PRICEWATERHOUSECOOPERS

CATERPILLAR DEALERS
LIKE-KIND EXCHANGE PROGRAM

EXECUTIVE SUMMARY

A tax planning opportunity exists that would provide significant tax savings to certain dealers[1] of Caterpillar equipment. The idea involves the implementation of a like-kind exchange program under §1031 of the Internal Revenue Code[2]. This like-kind exchange program could be implemented for the disposition and replacement of equipment included in the rental fleets of Caterpillar dealers ("dealers").

Under this program, the dealers would be able to defer recognition of any gain realized, including §1245 depreciation recapture income, on the disposition of their rental fleet equipment (i.e., delay payment of tax), provided that (1) the old equipment is replaced with new equipment ("replacement property") that costs at least as much as the proceeds from the sale of the old equipment, and (2) the dealer does not, and cannot, have access to the sales proceeds with respect to the old equipment.

Because it is impossible, as a practical matter, for dealers to acquire replacement equipment from the buyers of old equipment, a third party, generally called a "qualified intermediary," must be involved. The qualified intermediary is an unrelated party, such as a bank, that is used to facilitate the exchange. Under the like-kind exchange rules, the qualified intermediary must acquire the old equipment from the dealer, transfer the old equipment to the purchaser, acquire the replacement equipment from the seller, and transfer the replacement equipment to the dealer, all as part of an overall exchange process. These transactions are accomplished largely through contractual provisions. The purchaser of the old equipment and the seller of the replacement equipment have no direct dealings with the qualified intermediary; the qualified intermediary simply receives the proceeds from the sale of the old equipment and disburses those proceeds to purchase the replacement equipment.

The following is a simplified example of a like-kind exchange under this program. A dealer initially purchased a tractor for its rental fleet for $100,000, and now wishes to dispose of this tractor and acquire a new replacement tractor. The dealer's adjusted tax basis in the old tractor is $40,000, and the fair market value of the old tractor is $55,000. Instead of recognizing a $15,000 gain on the sale of the old tractor, the dealer, using a qualified intermediary, exchanges the old tractor for a new, replacement tractor that costs $100,000.

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[1] It appears that there is disparity among the dealers with regard to how the dealers account for the equipment in their rental fleet. For example, some dealers may treat their rental fleet equipment as inventory, while others treat it as depreciable property. Those dealers who treat their rental fleet equipment as inventory would not be eligible for the like-kind exchange program.
[2] All section or "§" references are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

The steps are as follows: The dealer first locates an unrelated third party to purchase the old equipment. To facilitate the like-kind exchange, the dealer assigns the right to sell the old tractor to a qualified intermediary, which then sells the tractor to the unrelated third party for $55,000. The qualified intermediary holds the $55,000; the dealer cannot access the sales proceeds at any time during the exchange transaction. The dealer then locates replacement equipment and enters into a contract to purchase the replacement equipment. The right to purchase the replacement equipment is then assigned to the qualified intermediary. Since the price of the replacement equipment exceeds the sales proceeds, the dealer will provide the qualified intermediary with the balance of $45,000. The qualified intermediary then uses the $100,000 of cash ($55,000 in sales proceeds and $45,000 from the dealer) to purchase the new tractor and transfers it to the dealer. The dealer's basis in this new tractor is $85,000 (the $40,000 of basis in the old tractor plus the $45,000 cash provided to the qualified intermediary). If the dealer had sold the old tractor, tax would have been due on the $15,000 of §1245 depreciation recapture income.

The $15,000 gain is not eliminated; however, the gain is deferred until the dealer disposes of the equipment in a transaction that does not qualify for like-kind exchange or other non-recognition treatment.

The details of the tax rules underlying this deferral technique are described in the attached memorandum.

To allow the dealers to maximize the potential benefits under a like-kind exchange program a system needs to be implemented to minimize transaction costs. The second attachment outlines a proposed computer system that will utilize existing information in the dealers' computer systems to allow for automation. The final design of this system will be based on discussions with the dealers to make sure it serves their needs as simply as possible.

SECTION 1031 LIKE-KIND EXCHANGES

General Rule

Section 1031(a) provides that—

> No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like-kind which is to be held either for productive use in a trade or business or for investment.

Thus, the four general requirements for nonrecognition treatment under §1031 are: (1) both the property surrendered and the property received must be held either for productive use in a trade or business, or for investment; (2) the property surrendered and the property received must be of "like-kind"; (3) the property must not be described in the list of ineligible property contained in § 1031(a)(2); and (4) there must be an exchange, as distinguished from a sale and repurchase.

Held For Productive Use in a Trade or Business or For Investment

Neither the Code nor the Treasury regulations thereunder define the term "held for productive use in a trade or business." However, the Internal Revenue Service has ruled that rental fleets such as the fleets maintained by certain dealers qualify as property held for productive use in a trade or business. PLR 9627014. Accordingly, subject to the limitations described in this memorandum, the equipment held by the dealers for use in their rental fleets can be exchanged in a like-kind exchange.

"Like-kind"

The requirement that the exchanged properties be of "like-kind" has reference to the nature or character of the property and not to its grade or quality. See Treas. Reg. §1.1031(a)-1(b). To qualify for like-kind exchange treatment, one kind or class of property may not be exchanged for property of a different kind or class. Depreciable tangible personal properties are of a like class if they are either within the same General Asset Class, as defined in Treas. Reg. §1.1031(a)-2(b)(2), or within the same Product Class, as defined in Treas. Reg. §1.1031(a)-2(b)(3).

Treas. Reg. §1.1031(a)-2(b)(3) states that property within a Product Class consists of depreciable tangible property that is listed in a four-digit product class within Division D of the Standard Industrial Classification codes ("SIC codes"), set forth in Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual (1987) ("SIC Manual").

Under the Caterpillar like-kind exchange program, the dealers would be exchanging old equipment used in their rental fleets for new equipment to be used in their rental fleets.

For example, it is envisioned that under this program, a dealer would exchange an old asphalt paver that was used in its rental fleet for a new asphalt paver to be used in its rental fleet. In this instance, the property exchanged will be considered like-kind property, since the exchange consists solely of the exchange of an old piece of equipment for a new piece of identical equipment.[3]

Furthermore, since Treas. Reg. §1.1031(a)-2(b)(1) states that property will be considered to be like-kind if exchanged for property within the same General Asset Class or same Product Class, the properties exchanged do not have to be identical to one another. Caterpillar and its dealers will be able to ensure that the equipment being exchanged constitutes like-kind property by replacing old equipment classified within one SIC code with new equipment classified within the same SIC code. For example, construction machinery classified within SIC code 3531 should only be replaced with construction machinery that also falls within SIC code 3531. More precisely, since they all are listed as construction equipment under SIC code 3531, a dealer could replace an old backhoe with a new backhoe, a new asphalt drum compactor, a tractor, or any other equipment listed in under SIC code 3531.

Property Must Not Be Described in the List of Ineligible Property

Section 1031(a)(2) specifically excludes certain types of assets from nonrecognition treatment. In particular, inventory held by a taxpayer is not eligible for like-kind exchange treatment. Section 1031(a)(2)(a). This type of property is neither used in a trade or business nor held for investment. Thus, dealers who account for their rental fleet equipment as inventory would not be eligible to participate in the like-kind exchange program.

There Must Be An Exchange as Distinguished From a Sale and Repurchase

An "exchange" generally involves a reciprocal transfer of property as distinguished from a transfer of property for money or its equivalent. In the simplest example, a swap of a tractor in Dealer A's rental fleet for a tractor from Dealer B is an exchange whereas a sale by Dealer A of a tractor from its rental fleet for cash, followed by a purchase by Dealer A of a tractor from Dealer B using the cash from the initial sale is a sale and purchase.

Deferred Exchanges

Very often, it will be difficult, if not impossible, for a dealer to arrange for a simultaneous exchange of old equipment (sometimes referred to as the "relinquished property") for replacement equipment. The Code addresses this problem by permitting deferred exchanges. Under these rules, the dealer must "identify" replacement equipment on or before the day which is 45 days after the date on which he transfers the relinquished

[3] We understand that, due to product improvements and modifications, the piece of replacement equipment may not be *exactly* identical to the relinquishment property; however, the overall use and function of the equipment will not have changed.

property *and* must receive the replacement property no later than the earlier of (A) the day which is 180 days after the date on which the dealer transfers the relinquished property and (B) the due date (determined with regard to extension) for the dealer's tax return for the taxable year in which the transfer of the relinquished property occurs. The dealer cannot actually or constructively receive the proceeds of the sale of the relinquished property until they actually receive the replacement property. Failure to satisfy any of these requirements results in non-like-kind treatment, *i.e.*, in a fully taxable transaction.

Qualified Intermediaries

To ensure that the dealers do not actually or constructively receive the proceeds of the sale of the relinquished property, the Caterpillar like-kind exchange program will utilize a qualified intermediary that falls within the safe harbor provided in Treas. Reg. §1.1031(k)-1(g). The agreement between the dealer and the qualified intermediary will expressly limit the dealer's rights to receive, pledge, borrow, or otherwise obtain the benefit of money or other property held by the qualified intermediary. The agreement will also provide that the qualified intermediary will acquire the relinquished property from the taxpayer, transfer the relinquished property, acquire the replacement property, and transfer the replacement property to the dealer. These transactions are accomplished through the following steps:

- dealer enters into a contract to sell the relinquished property;
- dealer assigns the rights under the sales contract to sell the relinquished property to the qualified intermediary and notifies the buyer of the assignment;
- the relinquished property is transferred pursuant to the sales contract;
- dealer enters into a contract to purchase the replacement property;
- dealer assigns the rights under the purchase contract to purchase the replacement property to the qualified intermediary and notifies the seller of the assignment;
- the replacement property is transferred pursuant to the purchase contract.

But for the notification of the assignments and the direction of the sales proceeds to and from the qualified intermediary, neither the purchaser of the relinquished property nor the seller of the replacement property are involved in the transaction in any way.

Results of a Successful Like-kind Exchange

In a successful like-kind exchange, no gain or loss is recognized. Rather, gain or loss is deferred until the dealer exchanges or disposes of a piece of equipment that was acquired in a like-kind exchange for money or property in a transaction that does not qualify for like-kind exchange or other non-recognition treatment.

The tax basis of property received in a like-kind exchange generally is the same as the adjusted basis of the relinquished property with the following adjustments:

- Basis is increased by the amount of any money paid by the dealer in excess of the proceeds from the sale of the relinquished property and is decreased by the amount of any money received, and
- Basis is increased by the amount of any gain recognized or decreased by the amount of any loss that was recognized.

Sections 1011, 1031(d).

The Caterpillar Like-kind Exchange Program

The Caterpillar Like-kind Exchange Program will facilitate the like-kind exchanges by centralizing the transactions through a single qualified intermediary. Once the appropriate qualified intermediary has been chosen, a Master Exchange Agreement must be entered into among the participating dealers and the qualified intermediary. This Master Exchange Agreement will define the roles and responsibilities of each party with respect to the like-kind exchange program. In addition, this Master Exchange Agreement also will contain the appropriate language needed to assign the necessary rights to the qualified intermediary. The Master Exchange Agreement also will reflect a mechanism for providing the appropriate notifications to parties of the assignments of rights under the Master Exchange Agreement.

Under the Master Exchange Agreement, the qualified intermediary will establish an account at a financial institution unrelated to the dealers, which will be maintained by the qualified intermediary in the name of the qualified intermediary. As specified in the Master Exchange Agreement, the qualified intermediary will deposit the proceeds from dispositions of relinquished property into the qualified intermediary's account. The dealers will be notified on a regular basis of the amount of proceeds deposited.

The purchase of the replacement property in an exchange governed by the Master Exchange Agreement will be funded by the qualified intermediary with the proceeds from disposition of relinquished property deposited in the qualified intermediary's account. To the extent that the funds in the qualified intermediary's account are insufficient to pay for the replacement property, a dealer will have to fund the deficiency. A listing identifying acquired replacement property will be compiled on a regular and timely basis.

BENEFITS AND BURDENS OF LIKE-KIND EXCHANGE PROGRAM

The benefit of the like-kind exchange program is that the dealers can dispose of and replace equipment in their rental fleet without recognizing any taxable gain on the transaction, including §1245 depreciation recapture. By exchanging one piece of rental

equipment with a new, similar piece of equipment, a dealer will simply be "rolling over" the basis of the old equipment to the new equipment being acquired. This "roll over" of basis will continue until a dealer disposes of a piece of equipment acquired in the like-kind exchange program for property other than like-kind equipment (e.g., if the dealer sold the equipment to a customer for cash). At that time, the dealer would recognize gain on the disposition of the equipment. By participating in this program, the dealers will enjoy significant tax savings.

One burden associated with this like-kind exchange program is that the proceeds from the sale of the old equipment will be unavailable to the dealer while they are held by the qualified intermediary. Between the time that the relinquished property is sold and the replacement property is received, a dealer may not have access to the sales proceeds held by the qualified intermediary and may not pledge them as security for a loan. The dealer may, however, be paid interest while the funds are on deposit with the qualified intermediary.

Another burden would be the identification and designation process to which the dealers would have to conform under the like-kind exchange program. As stated previously, the replacement property must be identified within 45 days. In addition, the dealers must designate the replacement property as strictly for use in their rental fleet. Thus, if a dealer received a piece of equipment as replacement property, the dealer could not routinely sell that piece of equipment to a customer. The replacement equipment must be acquired for use in the rental fleet, not as inventory held for sale to customers. This identification and designation process will be achieved by keeping track of vehicle identification numbers that are unique to each piece of equipment. Working with Caterpillar and the participating dealers, PricewaterhouseCoopers LLP will create a computer-based tracking system that will be used to match sales with replacements and track depreciation on new equipment.

4/27/99

Purpose

The purpose of this document is to define the scope of the project to implement the PricewaterhouseCoopers LLP ("PwC") proprietary Like-Kind Exchange software ("LKE System") in connection with the implementation of the Like-Kind Exchange Program for Caterpillar Dealer's rental equipment). This document will also identify the following:

- Deliverables that the LKE System will provide to achieve project objectives.
- Requirements that Caterpillar dealers will provide to PwC to achieve these deliverables.

Project team members from Caterpillar, selected dealers and PwC will jointly approve these requirements and deliverables.

Scope of LKE System Processes

The following is an outline of the processing services that will be provided by the LKE System for the Caterpillar LKE Program:

- The LKE System will utilize Daily/Weekly data extract files provided by the DBS system resident at each Caterpillar dealer. These extract files will contain sold units on order and units that have been received.
- PwC will provide Caterpillar with detailed specifications for the fields and calculations that must be provided in these extracts.
- These extract files will be processed in the LKE System to calculate depreciation on all the assets in dealer rental portfolios for all "tax books" specified by the Caterpillar dealers using the depreciation methods and conventions defined by Caterpillar dealers. The LKE System will calculate depreciation on a single basis amount for each book and has the ability to store data for up to 9 tax books.
- The LKE System will use the extract file data to match eligible relinquished units with eligible replacement units (units received within 45 days of relinquishment date or units on order) as prescribed by the Internal Revenue Service ("IRS") rules and regulations for Sections 1031.
- Users of the system will be notified and prompted to confirm the system's preliminary matching.
- The LKE System will match eligible relinquished units with eligible replacement units as prescribed by the rules and regulations for the states of Georgia and Oregon.
- The LKE System will calculate the tax gain(loss) amount for terminated units.
- The LKE System will calculate the adjusted tax basis for matched replacement units.
- The LKE System will use an initial extract to load the Caterpillar dealer's portfolio into the LKE database. Depreciation on all units will be calculated at this time. Matching will be performed on units received on the Daily/Weekly feed after the initial load.

Description of LKE System Deliverables

The following standard reports (delivered via paper or on-line) will be generated by the LKE System based upon the processing described above:

- A Daily/Weekly Relinquished Units Report that displays all relinquished units processed for the day. This report will be used by the Caterpillar dealer's tax department and a copy sent to the Qualified Intermediary.
- A Daily/Weekly Replacement Units Report that displays all replacement units processed for the day. This report will be used by the Caterpillar dealer's tax department and a copy sent to the Qualified Intermediary.
- A Matching Report sorted by units type that shows units that are matched to similar replacement units based upon the IRS rules for Section 1031. The frequency of this report to be determined by the Caterpillar dealer's tax department.
- A Daily/Weekly Unmatched Relinquished Units Report that displays unmatched relinquished units after the required 45/180 period limits for section 1031. The report will also provide the possible causes for unmatched units resulting from errors.
- A Daily/Weekly Unmatched Replacement Units Report that displays unmatched replacement units after the required 45/180 period limits for section 1031.
- A Daily/Weekly Error & Exception Report that displays any errors or exceptions which occurred during the load process of the Daily/Weekly extract file.
- A Monthly Gain(Loss) Report generated each month to display the gain(loss) for terminated units processed for the current month.
- A Monthly Tax Depreciation Report that display year-to-date tax depreciation and tax gain(loss) information as of the end of each month.
- An Annual Acquisitions & Dispositions Report displaying all dealer acquisitions and dispositions for the prior calendar year.
- An Annual Depreciation Report for all tax books as defined collectively by Caterpillar dealers that will display the depreciation expense calculated on an annual basis of assets that are depreciated in the LKE system to be run on a date specified by the dealer. This report will be used by the Dealer's tax department for preparation of the tax return.

The following non-report deliverables will be provided by the LKE System:

- The Report Requester Interface allows dealers to create ad-hoc reports from the data stored in the LKE system, based upon standard reporting types, such as Depreciation, Matching, etc. The user will have the ability to enter such parameters as dates, sorting, or filtering.
- The Table Maintenance Interface allows dealers to access the tables on the application server to conduct any required maintenance.

- All reports generated by the LKE System will be stored on an FTP server at PwC. The reports will be created using Crystal Reports and stored as PDF files. Reports will be grouped in directories by type and date in LIFO order. PwC will deliver a Web interface to navigate the report archive.

- PwC will provide a Depreciation worksheet to dealers, available on-line, that will be used to implement the specific depreciation methods, conventions, and lives required for each tax book to be reported on.

- PwC will provide User Procedures and basic system documentation to dealer personnel responsible for maintaining the LKE System after the system is launched.

PwC will be responsible for all systems analysis and design, program development, and testing of customizations to the LKE System to meet the requirements of the Caterpillar LKE Program.

Description of Requirements to be Provided by Caterpillar

In order to meet project objectives and successfully implement the LKE System, Caterpillar and selected dealers will provide the following to PwC:

Systems Deliverables:

- Assistance in creating a methodology for creating a daily/weekly extract of inventory and order information from the DBS system. The extract will meet the defined specifications provided by PwC.

- Caterpillar and PwC will agree on definitions and the 4 digit SIC codes of all units available to dealers.

- Caterpillar and the dealers will define the state codes used in DBS system, as well as any other pertinent codes such as status codes, sale type codes, and unit description codes. The state codes will be provided in a two column text file that contains the state code used by the leasing system and the corresponding two letter postal code. Caterpillar/dealers will be responsible for maintaining these state codes once the system has been implemented.

Depreciation Deliverables:

- Caterpillar and dealer representatives will provide to PwC any specific state tax books to be reported on, and the depreciation conventions and methods used for all federal and state tax books that the LKE System is reporting on. The specific asset life for each tax book should also be provided.

- Caterpillar and/or dealer will complete the depreciation worksheet provided by PwC.

- Dealer will specify any short-year depreciation methods and conventions that need to be utilized by the LKE System.

- Dealer will identify all legal entity and region groupings, and all assets within the Caterpillar portfolio must be mapped to one of these legal entity and/or region groupings for tax depreciation purposes.

Like-kind Exchange Program
April 27, 1999

"Proposed" Caterpillar Dealer LKE System Process